A Response

to the Minister's Discussion Paper

on

Public Sector Pensions

Public Service Pension Plan

Alberta

Public Service Pension Plan Board

September 30, 1991

Alberta
GOVERNMENT PENSION BOARDS

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September 30, 1991

The Honourable Dick Johnston
Provincial Treasurer &
Minister Responsible for
Public Sector Pensions
224 Legislature Building
EDMONTON, Alberta
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Sir:

Subject: Response to the Proposed Plan Changes

On behalf of the Public Service Pension Plan Board, I have the honour to submit our initial response to your July 9, 1991 proposal "Planning Responsibly for the Future - A Discussion Paper on Public Sector Pensions" in respect of the Public Service Pension Plan.

Yours truly,

J. E. Faries, FCIS
Chairman

Encl.

TABLE OF CONTENTS

	Page
Preface	1
Members of the Board	3
Executive Summary	4
History of the Plan	6
Funding	9
Benefit Changes	12
Governance	17
Recommendations	19

PREFACE

On July 9, 1991 the Minister responsible for public sector pensions released a discussion paper[1] that outlined a number of proposed changes to the Public Service Pension Plan (PSPP). The Minister asked the PSPP Board, which is composed of employee, employer and government representatives, to respond to the proposal.

At the meeting members of the five pension plan boards[2] were in attendance to receive the proposal. In addition there were representatives of employee and employer organizations and other interested parties. The Minister invited all present to comment on the proposal. He gave the Boards until September 30 to file their reports with him. He stated that in his view the boards would be the conduit by which he would receive comments from other parties.

Our response must be considered in light of the following:

1) Many of the Board's recommendations are contingent upon further discussions with the Minister on specific issues such as governance.

2) Sufficient information was not available to develop alternative proposals. Treasury was able to provide adequate information to assess the specific proposal but there was not enough information to

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1 Planning Responsibly for the Future - A Discussion Paper on Public Sector Pensions; Alberta Treasury (July 1991).

2 Public Service Pension Plan, Local Authorities Pension Plan, Public Service Management Pension Plan, Universities Academic Pension Plan and Special Forces Pension Plan.

assess alternatives. For example, it was only after this report was drafted that Treasury released a separate accounting for each plan.

3) Some stakeholders are still developing their responses to the proposal.

The Board's response is unique in that it reflects the concerns of both employee and employer representatives and its recommendations can be viewed as consensus positions. One might argue that the employer and government are one and the same with regards to the PSPP. This is not necessarily true. Universities, Boards and Commissions[3] are significant employers under the plan. In addition to seeking input from employees and employers in those public bodies, the Board also solicited and received input from government departments as employers. As a result, this report distinguishes between government as plan sponsor and government as one of several employers under the plan.

The comments made in this report must be considered as a package and any one position taken by the Board must not be isolated from the conclusion reached by the whole report. Governance[4] is the key issue and underlies all the other recommendations made. Our intention in presenting this report is to commence a dialogue that is necessary to achieve a solution that would be acceptable to all parties to the "pension deal".

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[3] As at March 31, 1990 there were 49 employers participating in the plan with about 54,161 employee accounts. Source: Public Service Pension Plan; Annual Report; March 31, 1990, Alberta Treasury.

[4] "Governance" means participation in decision making that encompasses funding, plan design, investments and administration.

MEMBERS OF THE

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EXECUTIVE SUMMARY

The main concerns expressed to the Board included:

1) Historically, the plan was sponsored and guaranteed by the province. Throughout the plan's history, government has maintained and strengthened its grip on the decision-making process. Therefore, the decision to ask employees and employers to share in funding the past service unfunded liability is unjustified.

2) The plan should be properly funded in the future.

3) Formal recognition of indexing at 60% of Alberta CPI[5] was considered by the majority to be too low.

4) A number of plan provisions such as cancelling reciprocal agreements, eliminating prior service, and the application of the proposed early retirement reduction factors are regressive in nature.

5) The pension deal that was originally agreed to and implemented in the past appears to be no longer desirable by government. Under this proposal the pension deal will change from a partially funded provincially guaranteed defined benefit plan to a full self-funded employer/employee defined benefit plan. Unless the governance consequences of the "new pension deal" are properly addressed, there will be no legitimacy to impose the discipline of full self-funding on employees and employers.

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5 "CPI" means the Consumer Price Index as published by STATSCAN.

The Board responded to these concerns with specific proposals regarding current service costs, indexing, the unfunded liability and other benefits. In addition to providing recommendations on specific proposed changes, this report also examines the history of the plan. The common thread that binds this response together is governance. As a result, many of those responses are contingent upon the resolution of the governance issue.

Key recommendations include:

1) The governance of the PSPP be so established to provide joint trusteeship of stakeholders.

2) Combined employee and employer contributions be set equal to the annual pension cost[6] of the pension plan upon recommendation number one being implemented.

3) Indexing be formally recognized as part of the pension formula at a minimum level of 60% of Alberta CPI with the ability of the trustees of the plan to enhance the level up to 100% when the funding allows.

4) A number of plan provisions, such as the provision to purchase prior service and reciprocal transfer agreements, must be retained on the basis that they be properly funded.

5) Early retirement reduction factor on service after January 1, 1992 be set at 3% for each year the member retires early.

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6 "Annual pension costs" means the cost required to fund current service benefits and any plan deficiencies over a specified period of time (eg. 15 years).

HISTORY OF THE PLAN

In reviewing the Minister's proposal, it is important to understand the historical context of the plan. This is particularly important when attempting to define the "pension deal" as it applies to the PSPP.

The Public Service Pension Plan[7] (PSPP) was introduced in 1947 to provide a defined benefit pension plan for members of the public service. It replaced the Superannuation Plan[8], a money purchase plan in effect at that time. Boards and Commissions were added to the list of participants at various times over the ensuing years. The PSPP is the second largest of the five plans when measured on both a membership and financial basis. Further, it currently enjoys a large positive cash flow, due in part to a series of contribution rate increases that began in 1985.

While the benefit structure has been largely unchanged since 1966, when the plan became integrated with the Canada Pension Plan (CPP), the funding of the plan has evolved over time. Initially, the plan was "terminally funded". Employee and employer contributions were paid to the General Revenue Fund (GRF). All retirement benefits were paid from the GRF and were therefore "funded" by the government. The plan was considered "secured" because of the perpetual nature of government and the presence of the government guarantee of the benefit. It could be argued that this funding arrangement was considered desirable by all parties involved. Employees received, and the employers provided, a benefit for a fixed cost without the necessity of pre-funding, while the government, in exchange for absorbing the financial risk of the plan, had at its disposal a captive pool of financing.

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7 See the Public Service Pension Act (1947); Chapter 7 Revised Statutes of Alberta (R.S.A.).

8 See: The Superannuation Act, (1927); Chapter 8 R.S.A.

Rates were originally set at 5% for both the employees and employers. Rates were changed in 1966 to reflect the impact of integration with the CPP to 3.5%/5.0% for employees and employers. In 1985 there were a series of phased increases to 1989, raising the rates to the current 4.375%/6.25% for employees and employers. It should be noted that the government as an employer made no contributions to the plan from 1952 to 1981 while Boards and Commissions continued to contribute an employer share.

During the 1970's there was a commitment to impose a form of funding discipline on the plan. In the 1970's new plans were created for senior public service managers, for academic staff at universities and for members of police forces. In setting the contribution rates for those plans, it was agreed that if the contribution rates would generate a positive cash flow over a pre-determined period into the future (i.e. 30 years) then the contribution rates would be considered to be meeting the "cost" of the plan.

In 1981, the government created a "pension fund"[9]. This fund was considered to be a fiscal management device of government to offset the growing liability of the collective pension obligations guaranteed by the province. The government made an "initial deposit" of $1.1 billion. Mr. Hyndman's announcement suggests a decision on the part of government to pre-fund benefits[10]. The announcement did not make any commitment for employees to fund past service. Instead, it suggests that any accumulated deficits would be funded through surpluses in the GRF. Unfortunately, 1981 was the last time a surplus occurred. As a result, no additional money was put into the Fund except for net contributions from the five plans.

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9 See the Pension Fund Act; (1981), Chapter P-3.1 R.S.A.

10 Alberta Hansard, March 28, 1980, p.122.

The plan was initially administered by the Public Service Pension (PSP) Board. The PSP Board continued to administer the plan until 1985 when the administrative responsibility was transferred to the Minister[11]. It should be noted that the term "administration" is used in the context of delivering the legislated benefit. Thus, while employees had representation on the Board through to 1985, the critical decisions associated with the sponsorship of a pension plan (i.e. funding, benefit design, investment management, etc.) were controlled by the government.

From the historical perspective two conclusions can be drawn:

1) Government through its multiple role of plan sponsor, guarantor, employer, investment manager, and administrator has dominated plan decision-making.

2) The funding objective has evolved through time. Initially the plan was funded on a terminal basis, then through a cash flow discipline, and currently on a partially funded basis.

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11 See the Public Service Pension Plan Act; (1984), c.P-35.1, Section 3.

FUNDING

To secure the financial base of the plan the government's proposal notes that "true pension security for employees requires that all benefits be fully funded and backed by marketable assets." To achieve this goal the proposal goes on to recommend that:

1) The cost of liquidating the past service unfunded liability of the five plans be equally shared by employees, employers and the government.

2) Future service be paid, as it accrues, by employers and employees by requiring that contribution rates be adjusted to reflect the "annual pension cost".

3) The indexing promise be formally recognized at 60% of inflation for both past and future service.

This represents a fundamental change to the pension deal. No longer will the pension promise be secured by the government guarantee but by the ability of plan assets to generate a sufficient rate of return. Under the Minister's proposal, effectively two thirds of the funding risk associated with the past service unfunded liability and all of the funding risk associated with future service will be transferred from the government to employees and employers by imposing the discipline of self-funding.

These proposed changes will transform the plan from a partially funded, government sponsored defined benefit pension plan to a full, self-funded employee and employer shared risk-reward arrangement.

The Unfunded Liability:

The Minister's proposal asks that employees, employers and the government each contribute 1% of payroll to liquidate the unfunded liability of all the plans over a period that could be as long as 45 years.

It is the view of the Board that the province sponsored and guaranteed the plan therefore the past service unfunded liability is the government's responsibility. Under the existing governance of the plan there is no reason or obligation for employees or employers to share in the liquidation of the past service unfunded liability. **The Board recommends that:**

1.1 The government accept the full responsibility for the past service unfunded liability and liquidate it over a fixed period.

Current Service Costs:

To eliminate any liability for future service earned under the plan, the Minister proposes that the contribution rate for employees and employers be adjusted periodically to reflect the annual pension cost. Annual pension cost would include the amortization of any deficit so created due to an introduction of a new benefit, a change in the underlying demographics or adverse experience related to investment, inflation or wage levels. Effectively, the total funding risk for the plan would be transferred to employees and employers.

The consensus view of the Board is that employees and employers are willing to pay for service earned in the future. The majority view was that employees and employers should share in that responsibility. Because of the transfer in risk that

this entails, the consensus view of the Board is that a new structure for governance must be put in place to address employee and employer concerns over funding, plan design, investment policy and administration decision making. **The Board recommends that:**

1.2 Employees and employers accept the responsibility for funding future service earned under the plan upon implementation of a new form of governance.

Indexing:

The Minister's proposal recommends indexing of pensions based on 60% of inflation rather than on an ad hoc basis.

Formula indexing is desirable so that plan members can be assured of a predictable level of inflation protection. Further, in cases of termination or marriage breakdown, the value of the pension asset can be properly determined if indexing is on a formula basis. Therefore, the consensus view of the Board is that indexing should be formally recognized in the pension deal. The majority view is that 60% of CPI is not sufficient and represents a deterioration from what has been granted via ad hoc adjustments in the past. The desired level of indexing is 100%. The Board views the 60% to be a minimum rate of indexing and would like to see the ability to provide ad hoc increases up to 100% should plan experience allow for it. **The Board recommends that:**

1.3 A minimum indexing formula for pensions in payment and deferred pensions be formally recognized at a minimum of 60% of Alberta CPI and ad hoc adjustments up to 100% be granted if surpluses occur or additional funding is provided.

BENEFIT CHANGES

The Minister's proposal has two other expressed goals:

1) **Meet the new Federal Income Tax rules.**

2) **Improve portability of future service benefits.**

Before responding to specific recommendations in the proposal, it is important to understand the impact and significance of these changes.

In terms of the new Federal income tax rules, compliance is obviously required. However, as noted earlier, Federal income tax rules provide minimums and allow for the "grand-fathering" of pre-1992 service.

Portability, which is the ability to transfer service between pension plans, has been a long standing issue of concern among the PSPP participants. Currently, an employee can only withdraw his contributions plus 4% interest when leaving the plan. The alternative is to transfer service through a reciprocal agreement[12] if one exists between the two plans.

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[12] There are currently 33 agreements in place between the PSPP and other public sector plans across Canada. Source Public Service Pension Plan- Annual Report; Alberta Treasury (March 31, 1990).

Federal Income Tax Rules:

The treatment of early retirement factors has been highlighted by the Board as an example of where the government's proposal goes far beyond the minimums required for compliance.

Under the Minister's proposal, early retirement factors would increase to 5% (phased in over three years) and would apply to all service. This results in a substantial decrease in benefit to all plan members. This would be particularly apparent in the case of deferred pensions which would be substantially lower than projected when elections of deferred pensions were made.

With regards to the application of the 5% reduction factor to past service, it should be noted that in the actuarial analysis[13] released to the Board it was not clear whether this change was adequately reflected in the calculation of the accrued liability for past service.

Discussion with Treasury's actuary suggests that the 5% factor was applied to future service only. This means the accrued liability already incorporates the cost of grand-fathering the old reduction factors. The Board has asked for clarification but, at the time of writing, has not received a formal response from Treasury. **The Board recommends that:**

2.1 Pre-1992 service be grand-fathered using the old early retirement factors.

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13 Wyatt's analysis May 1990.

The Board does acknowledge that there is a cost to applying the minimum 3% factor just to future service. Moving to a 5% reduction factor is a dramatic change from past practices and will have a tremendous impact on human resource planning of employers. Governance is raised once again. While 5% may be more actuarially sound, if employees and employers are willing to pay the cost of the subsidy why not use 3%? **The Board recommends that:**

2.2 Service earned after 1992 be reduced using a 3% early retirement reduction factor for each year a member retires early.

Other changes are being made by regulation to meet the Federal tax reform, the Board continues to rely upon the Minister's commitment to allow the Board to see and comment on the regulations before they are implemented.

Portability:

The Minister's proposal provides for the introduction of the "50% rule"[14] for service earned after the date of implementation. As well, a market rate of interest will be calculated on employee contributions after the date of implementation. Reciprocal transfer agreements will be cancelled and transfers between the Alberta family of provincially sponsored pension plans will be allowed but on a basis that "minimizes" their financial impact.

The Board supports the move to improve the termination benefit under the plan. There was considerable discussion by the Board regarding the retroactivity of the

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[14] The 50% rule is based on calculating the commuted value of a pension with the employer required to pay at least half of the commuted value; see EPPA, Section 29.

proposal and the calculation of the termination benefit itself. Questions raised by the Board included:

1) Should the market rate of interest be applied to all contributions to date or only to contributions received from 1992?

2) Should the termination option include both employee and employer contributions as well as a market rate of interest?

The Board acknowledges that improved termination benefits, over and above the Minister's proposal would cost the plan more. Sufficient information to assess those additional costs was not available to the Board. However the discussion indicated a willingness to pursue the issue further. It also underscored the need to address governance to allow employers and employees to assess the cost/benefit trade-offs in plan provisions.

The Board does not support the move to cancel reciprocal agreements. It seemed unfair to enhance the termination benefit for future service only and then eliminate reciprocal agreements which would apply to all service. Existing reciprocal agreements have been criticized because they do not allow the transfers to occur on a fully funded basis. A series of transfers into the plan could have the effect of importing unfunded liability. It has been assumed in the Minister's proposal that the actual cost to the plan over time has been substantial but this has not been fully documented. If the problem is how the transfers are priced, instead of cancelling the agreements, an effort should be made to modify their costing basis. **The Board recommends that:**

3.1 Reciprocal transfer agreements be continued on the basis that transfers are "cost-neutral" to the plan.

Prior Service:

The proposal also calls for the elimination of prior service purchases.

The ability to purchase prior service is important to employees who leave and re-enter a particular industry through different employers. By being allowed to purchase prior service, the employee has an opportunity to participate in a defined benefit plan and is not by default forced to rely on a money purchase arrangement. The Board recognizes that some restrictions should be applied to time limits and type of qualifying service. However, as long as the prior service is "priced" on an actuarial or "cost-neutral" basis, then whether the service is purchased or not is not consequential to the plan. **The Board recommends that:**

4.1 Prior service be allowed to be established as pensionable on an actuarially sound or "cost-neutral" basis to the plan.

GOVERNANCE

These proposed changes will transform the plan from a partially funded, government sponsored defined benefit pension plan to a full, self-funded employee and employer shared risk-reward arrangement. As observed by a number of Board members, the provincial guarantee, once so important in securing the pension promise, will become redundant through time.

These proposed changes have provoked a discussion of governance among employees and employers in terms of:

1) **Accountability/participation in decision making to manage their newly acquired risk.** In "fixing" the funding, the government has fundamentally altered the incidence of risk within the plan. For service accrued after 1992, adverse investment experience, aging in the underlying plan demographics or a change in plan assumptions will be immediately reflected in higher contribution rates. Experience losses (gains) attributable to service prior to 1992 will expand or contract the effective amortization period and will be reflected in the total contributions made by employees and employers over the amortization period. Despite absorbing a significant portion of the risk, there will be no significant change in the governance of the plan as proposed by the Minister. However, if employees and employers are to adequately manage the risk that they must now absorb, they must be able to monitor, assess and effect decisions that impact on their risk.

2) **The cost effectiveness of benefit design to meet the needs of the participants.** Under a discipline of self-funding, the cost effectiveness of benefit design becomes more acute. The basic question of "Within the context of a specific industry, the tax environment and total compensation, are we getting good value for our money?" will be asked again and again. In terms of this proposal, there are a number of benefit changes such as the cost and adequacy of the proposed indexing formula that employees and employers may want to re-assess within the context of a shared risk-reward arrangement.

If the government wants employers and employees to share that fiscal responsibility (and there are indications that they are willing to do so) then that has to be reflected in how the plan is run. It is the view of this Board that if a shared risk-reward arrangement is to be imposed, the governance consequences must be recognized and addressed by the parties to the deal. For the arrangement to have "legitimacy", each party must articulate and accept its responsibilities and acknowledge the financial interests of the other parties. **The Board recommends that:**

5.1 The governance of the PSPP be established to provide joint trusteeship of stakeholders.

RECOMMENDATIONS

FUNDING:

1.1 The government accept the full responsibility for the past service unfunded liability and liquidate it over a fixed period.

1.2 Employees and employers accept the responsibility for funding future service earned under the plan upon implementation of a new form of governance.

1.3 A minimum indexing formula for pensions in payment and deferred pensions be formally recognized at a minimum of 60% of Alberta CPI and ad hoc adjustments up to 100% be granted if surpluses occur or additional funding is provided.

FEDERAL INCOME TAX RULES:

2.1 Pre-1992 service be grand-fathered using the old early retirement factors.

2.2 Service earned after 1992 be reduced using a 3% early retirement reduction factor for each year a member retires early.

PORTABILITY:

3.1 Reciprocal transfer agreements be continued on the basis that transfers are "cost-neutral" to the plan.

PRIOR SERVICE:

4.1 Prior service be allowed to be established as pensionable on an actuarially sound or "cost-neutral" basis to the plan.

GOVERNANCE:

5.1 The governance of the PSPP be established to provide joint trusteeship of stakeholders.